IN THE

Supreme Court of the United States

OCTOBER TERM, 1940

No.....

STEPHEN WESTOVER, Trustee in Bankruptcy of Grand Avenue Lumber Company, a corporation, Bankrupt,

Petitioner,
(Appellee Below)

vs.

VALLEY NATIONAL BANK, a banking corporation,

Respondent,
(Appellant Below)

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

This petition is submitted under the provisions of Section 240, Judicial Code, U. S. C. A., Title 28, Section 347, as amended, and Bankruptcy Act of July 1, 1898, as amended up to June 26, 1936, United States Code, Title 11, Chapter 6, Section 96.

The petition contains a statement of the main facts pertinent to the questions presented. Those facts were

set up somewhat in detail therein, but as concisely as was deemed consistent with a fair presentation of the matter to this Court. In the interest of brevity they will not be further elaborated in this brief but reference will be made thereto in connection with the argument of the errors charged.

The opinion of the Circuit Court of Appeals was filed May 22, 1940, was modified on June 19, 1940, and judgment became final on the latter date when motion for rehearing was denied. It is officially reported in 112 Fed. (2d) 61, (Advance Sheets No. 1, July 8, 1940, and is printed in the Record, pages 338 to 344.)

SPECIFICATION OF ERRORS

1. The court erred in reversing the judgment for appellee for recovery of a voidable preference in bankruptcy and awarding judgment to the appellant "upon the ground that the trustee has failed to establish knowledge, actual or constructive, of the bank that the payments made to it were *intended as a preference*", for the reason that the trustee was not required by the Bankruptcy Act to establish any knowledge of an intent to prefer. (Italics ours).

2. The court erred in holding that it was necessary for the trustee in bankruptcy, in order to recover as a voidable preference payments to a bank, to prove that the bank had knowledge that the payments were preferential rather than to prove "reasonable cause to believe" that they would "effect a preference".

3. The court erred in substituting its judgment on facts for the findings and judgment of the trial court in an action which had been tried by the court without a jury, by reviewing the evidence on a wrongful hypothesis of the proof required by the statute to sustain recovery of a voidable preference, and disregarding competent, material evidence in the record which sustained the findings of the trial court.

ARGUMENT

Taking up the errors charged seriatim, petitioner presents:

FIRST

The court erred in reversing the judgment for appellee and awarding judgment to appellant "upon the ground that the trustee has failed to establish knowledge, actual or constructive, of the bank that the payments made to it were intended as a preference" for the reason that under the provisions of the Bankruptcy Act, as effective since 1910, no duty was placed upon the trustee to establish knowledge, actual or constructive, on the part of a transferee that payments received and claimed to be preferential were *intended* as preferential payments. The duty placed upon the trustee is only to establish "reasonable cause to believe that the enforcement of the transfer would *effect* a preference."

The ground upon which the judgment for appellee is reversed clearly shows error on the part of the court

in construing the provisions of the Bankruptcy Act with respect to the burden placed upon the trustee in bankruptcy in establishing a preferential payment.

Section 60b of the Bankruptcy Act, as amended to June 26, 1936, and which was in effect in 1937, U. S. Code, Title 11, Chapter 6, Section 96, reads as follows:

> "If a bankrupt shall have procured or suffered a judgment to be entered against him in favor of any person or have made a transfer of any of his property, and if, at the time of the transfer, or of the entry of a judgment, or of the recording or registering of the transfer if by law recording or registering thereof is required, and being within four months before the filing of the petition in bankruptcy or after the filing thereof and before the adjudication, the bankrupt be insolvent and the judgment or transfer then operate as a preference, and the person receiving it or to be benefited thereby, or his agent acting therein, shall then have reasonable cause to believe that the enforcement of such judgment or transfer would effect a preference, it shall be voidable by the trustee and he may recover the property or its value from such person. And for the purpose of such recovery any court of bankruptcy, as hereinbefore defined, and any state court which would have had jurisdiction if bankruptcy had not intervened, shall have concurrent jurisdiction."

In Gilbert's Collier on Bankruptcy (4th Ed.) page 888, the following statement is made of the change in the Bankruptcy Act under the 1910 amendment:

> "Under the section as amended in 1910, if the creditor knows or has 'reasonable cause to believe that the enforcement of such judgment or transfer would *effect* a preference,' the transfer is voidable by the trustee without regard to the intent of the bankrupt."

The change was recognized in the following language used by the court in Heyman v. Third Nat. Bank of Jersey City, 216 Fed. 685, 688:

> "Intent to prefer since the amendment of 1910 is no longer material. The effect of the transaction is substituted for the intent of the debtor. Actual knowledge or even actual belief that a preference will result is not required. Neither knowledge nor belief but reasonable grounds to believe is made the criterion of proof in such cases."

In Cunningham v. Brown, 265 U. S. 1, 10, this Court has stated the requirement of the Bankruptcy Act in this connection to be as follows:

> "In order that a preference should be avoided, its beneficiary must have reasonable cause to believe that the payment to him will effect a preference; that is, that the effect of the payment will be to enable him to obtain a greater percentage of his debt than others of the creditors of the insolvent of the same class."

It is most evident from the language used throughout its opinion by the United States Circuit Court of

Appeals that it was considering the facts from an erroneous viewpoint by placing upon the trustee the wholly unnecessary burden of proving *that the appellant knew that the payments were intended as a preference.* An instance is noted in its statement (Tr. 343) "as to whether or not the payments made by the bankrupt were intended to be preferential and must reasonably have been believed such, * * * they (referring to the officers of the bank who testified) all testified that they had no knowledge of the insolvency of the bankrupt at the time the payments were made by it to the bank and *that so far as they were concerned there was no intent to make or receive a preferential payment*". (Italics ours).

It, therefore, cannot be urged that the ground given by the court for reversal of the judgment of the lower court was a mere error in statement and that notwithstanding this error the court was considering the evidence with the correct conception of the proof required under the Bankruptcy Act. Furthermore, the reversal of the judgment of the trial court, stating the ground therefor, sets a precedent and places a definite limitation on future actions by trustees in bankruptcy who seek to recover voidable preferences in an effort to effect equitable distribution of bankrupt estates.

If findings of fact and judgments of trial courts in cases tried without a jury are to be set aside by an appellate court, it should at least be done without ambiguous or misleading statements, either of law or fact, so as to correctly guide future litigation on the same subject.

SECOND

The court erred in its construction of Section 60b of the Bankruptcy Act by holding that it was necessary for the trustee in bankruptcy, in order to recover as a voidable preference, payments made to a bank, to prove that the bank had *knowledge* that the payments were preferential rather than to prove "reasonable cause to believe" that they would "effect a preference."

It is urged by petitioner that the court erroneously held that some sort of knowledge on the part of the bank that the payments were "preferential" must have been established by the trustee in order to recover and that it wholly disregarded proof of facts and circumstances known to the officer of the bank who handled the transaction, sufficient to put him on inquiry which would have revealed insolvency. The opinion of the court clearly discloses that it considered no duty of inquiry devolved upon the bank but that the trustee was required to bring home to the bank proof of some knowledge or definite conclusion on its part of the actual insolvency of the bankrupt at the time of the payments. This is contrary to the well established rule laid down by other Circuit Courts of Appeal that one who receives a payment otherwise preferential, who has knowledge of facts that would put a reasonably prudent man on inquiry, is charged with the duty of making such inquiry, and if he does not make it, is charged with notice of all the facts such an inquiry would have revealed.

The following cases clearly state this rule:

In the case of In Re Star Spring Bed Co., 265 Fed.

133, 136, 137, and in which testimony of the bank's officers bears a striking similarity to that given by the appellant's officers in the instant case, the Court of Appeals for the Third Circuit held that under section 60b of the Bankruptcy Act it was the duty of the bank *to make an inquiry*, saying:

> "The bank urges however that even though the Star Company was insolvent at the time of the transaction and the assignment of the accounts operated as a preference, yet neither it nor its agents engaged in the transaction then had reasonable cause to believe that the transfer of the accounts would effect a preference. In support of this contention the president and the cashier of the bank, the agents through whom the transaction was consummated testified that they then had neither knowledge nor belief that the Star Company was insolvent. Such evidence, however, is neither controlling nor, of much, if any weight; for under Section 60b of the Bankruptcy Act if the facts surrounding and attending the transfer were such as to cause a reasonably prudent man to believe that the bankrupt was insolvent or were such as to put such a person on inquiry touching the solvency of the debtor and such an inquiry would have disclosed insolvency, the transfer is voidable. * * * More obvious indications of insolvency it would be difficult to conceive; but "if these facts would not alone give to the bank reasonable cause to believe that the Star Company was insolvent they were more than sufficient to put it on inquiry. * * * It was the

> bank's duty under the law to make such inquiry, yet it accepted the assignment and completed the transaction without investigation. Notwithstanding its inaction, it is chargeable with such knowledge as the investigation would have disclosed. *Lethargy under such circumstances is not rewarded by the law.*" (Italics ours).

And it must be borne in mind that in the Star Spring Bed Company case the court held the testimony of the officers of the bank who handled the transaction that they had neither knowledge nor belief the debtor was insolvent, to be of little weight, while in the instant case the court held in effect that the testimony of officers of the bank who admittedly had no connection with the transaction—the officer who handled it being dead—that they had no knowledge of insolvency, or of "intention to prefer," was controlling as proof that the bank neither "knew nor should have known" the payment was preferential. This, petitioner contends, was erroneous.

The Circuit Court of Appeals for the Seventh Circuit in the case of Musk, et al. v. Burk, 58 Fed. (2d) 77, 79 in passing on the notice of circumstances inciting inquiry by one charged with receiving a voidable preference, used the following language:

> "That a preferential transaction shall be deemed voidable does not require that the person to be benefited should know that the result of the transaction would be to effect a preference, but it will be sufficient if the person preferred, or

his agent therein, have knowledge or notice of facts and circumstances that would incite a person of reasonable prudence under similar circumstances to make inquiry, as he is thereby charged with notice of all the facts which a reasonably diligent inquiry would develop. Collier on Bankruptcy (13th Ed.) 1300-1302; Essex National Bank v. Hurley, 16 F. (2d) 427 (C. C. A. 1); Coder v. McPherson, 152 F. 951 (C. C. A. 8).

"We believe that the District Court was warranted in its conclusion that a reasonably diligent inquiry here by the appellants or their agent in the community where they knew the bankrupt lived and had lived for twenty years would have disclosed the major portion of his indebtedness to others, and that the transaction would effect a preference."

Likewise the Circuit Court of Appeals for the Sixth Circuit, in the case of Buchanan State Bank v. De Groot, 39 Fed. (2d) 397, 398, in affirming the judgment of the District Court, and referring to a finding made by a referee in bankruptcy which was concurred in by the District Court, that:

"Facts within the knowledge of the cashier charged the bank with the duty of making inquiry touching the bankrupt's finances, which inquiry would have disclosed his insolvency and the preferential character of the assignment."

stated the rule in such cases as follows:

"This finding, concurred in by the District

Court, will not be set aside upon anything less than a demonstration of plain mistake. * * *

"There is no finding that the bank had actual knowledge of the insolvency when it took the transfer, but this is not necessary. In re States Printing Co., 238 F. 775 (7 C. C. A.); Boston Nat. Bank v. Early, supra. Equally inconclusive of the issue was the bank's evidence that it had no ground to believe the bankrupt was insolvent, in view of the finding, amply supported, as we think, by the testimony, that it had reasonable cause to believe that the use of the assignment would result in a preference, and had knowledge of facts putting it upon inquiry which would have disclosed Ross' insolvency and the preferential character of the transaction."

And in the case of Levy v. Weinberg & Holman (2 C. C. A.) 20 Fed. (2d) 565, 567, it was said with respect to the duty of a creditor to make an inquiry where he denies knowledge regarding a preferential transfer:

"It is argued that because the defendant denies knowledge, and there is no direct testimony to contradict his denial, there is no evidence to support a decree for the complainant. We cannot accept this contention. A creditor may not willfully close his eyes in order to remain in ignorance of his debtor's condition. It is incredible that Weinberg made these loans without any inquiry, if he had no knowledge of the bankrupt's circumstances."

Reviewing the requirements of the statute with regard to establishment as voidable of transfers condemned as preferential, the Circuit Court of Appeals for the Sixth Circuit said in Prudential Ins. Co. of America v. Nelson, 96 Fed. (2d) 487, 491:

> "Likewise must we reject the contention that the appellant had no reasonable cause to believe the bankrupt to be insolvent and that the payment would operate as a preference. * * * The statute condemns a transfer as preferential when the transferee has reasonable cause to believe that the transferor is insolvent and that it will effect a preference. It sets up a practical test, one with which courts are familiar and which in other transactions is frequently applied. If reasonable cause to believe a transferor insolvent and his transfer preferential in effect must wait upon complete audit and appraisal of a bankrupt's affairs, preferential transfers would rarely exist and the statutory protection to creditors be unavailing. Here were the signs which to a careful creditor pointed unerringly to a critical stage having been reached in its debtor's affairs"

See also:

Pender v. Chatham Phenix Nat. Bank & Trust Co. (2 C. C. A.) 58 Fed. (2d) 968;

Boston Nat. Bank v. Early (1 C. C. A.) 17 Fed. (2d) 691;

Brown Shoe Co. v. Carns, (8 C. C. A.) 65 Fed. (2d) 294.

That the operation of a payment as a preference must be determined by the actual effect of the payment as determined when bankruptcy resulted has been decided by this court in the case of Palmer Clay Products Co. v. Brown, 297 U. S. 227, 229, 80 L. Ed. 655, in which Justice Brandeis stated the matter as follows:

> "Whether a creditor has received a preference is to be determined, not by what the situation would have been if the debtor's assets had been liquidated and distributed among his creditors at the time the alleged preferential payment was made, but by the actual effect of the payment as determined when bankruptcy results. * * *
>
> A payment which enables the creditor 'to obtain a greater percentage of his debt than any other of such creditors of the same class' is a preference."

Reference is here made to the statement in the opinion of the Court (Tr. 340) that the receivership suit was filed on Shumway's direction on November 22, 1937, *after* the payments to the bank on that day of the two unmatured notes. This, as has been pointed out before is sheer conjecture as there was *no evidence whatever* as to the time of day of either incident. The appellate court apparently used this unwarranted assumption as a basis for its conclusion that the bank did not have *constructive knowledge* of the receivership when it accepted the payments on November 22nd. Of course if the suit was already filed when the payment was made, the bank had *constructive* notice of it, whether or not it had actual knowledge. While peti-

tioner believes the many other facts shown unmistakeably point to a situation which brought the bank within the requirement of the Act in putting it upon inquiry, if not giving it actual knowledge, as to the financial condition of the bankrupt, yet this statement is noticed because it illustrates the presumptions which the Court indulged in setting aside the findings of the trial court. It is a fact so well known that any court must take judicial notice of it that the filing of a receivership suit would require some forethought and preparation and it obviously was not decided upon by Mr. Shumway, prepared by his counsel and filed in court all after banking hours commenced on November 22nd. Furthermore there is Mr. Shumway's naive statement "I discussed all my business with Carl Gibson at that time" (Tr. 292). That statement was made by Shumway, a hostile witness called by the trustee, as the record discloses, directly after he had been questioned regarding his connection with the receivership filing. It cannot be presumed by anyone to mean anything less than its clear language indicates,—that he discussed the receivership with Carl Gibson. It is noticeable that he was not cross-examined by counsel for the bank on this matter.

From the facts clearly established, and cited in the petition, the trustee contended it was indisputably shown that Carl Gibson was the agent of the bank in all the transactions the bank had with the Grand Avenue Lumber Company and that his association with the affairs of the company through its president, Shumway, was extremely close from the time of its inception. That he knew of the financial condition of the company and that current accounts were not

being paid is disclosed by his statement made to Engstrom, a creditor, in August of 1937, and the fact that he knew where Shumway was and was able to dictate that the latter should return at once to Phoenix in order to prevent action being taken against the company bespeaks more than the role of the "casual observer" which was referred to in the opinion of the appellate court (Tr. 342).

However, one who accepts payment in full of its debt from an insolvent while possessed of undeniable knowledge of outstanding debts due others cannot thus lightly escape its responsibility, for the Bankruptcy Act, designed to protect all creditors equally, places a duty of investigation and inquiry on him. The bank had notice of all facts which were known to Carl Gibson, its agent, and Carl Gibson had notice for sixty days before payment to the bank on October 13th of its unmatured note, that the company was unable to meet its current accounts, had been threatened with one suit, and was borrowing to keep its account sufficient to pay expenses, he was consulted by Shumway about *all his business and any concern he did business with* and had been asked by Shumway just twenty-three days before this payment for a loan to the company of $20,000, which *Gibson refused* for the bank. To assume, as did the court in its opinion, that the only reason for this refusal by Gibson for the bank was "because it was too large for the capital" and that no inquiry was made as to the condition of the company or the reason for his good friend Shumway, who admittedly *talked over all business of the company with him*, asking for such a loan when the company at that time owed $6500 to the bank, is to do violence to the

well-known custom of "prudent" bankers. And to assume that Gibson did not know all about these payments would seem quite unreasonable in view of Shumway's testimony. However, since the payments *were* made and the bank records so showed, the bank was charged with notice. And whether or not Gibson made an investigation, which certainly would have revealed insolvency, is immaterial, for he *was charged with the duty*—and through him the bank *was so charged*—of making such investigation because he had knowledge of facts which should have put any prudent person—let alone a banker—upon inquiry.

Bankers in small communities (as was well-known to the trial judge who undoubtedly took judicial notice of that fact) keep in close touch from day to day with the affairs of those to whom they are extending credit. Indeed this was revealed by the testimony, quoted above, of Gus Engstrom, manager of a local concern, a creditor of the bankrupt, who sought out Carl Gibson, the banker, and asked him to advise him of the financial standing of this company.

While it was urged by appellant, as an indication that Carl Gibson did not believe the condition of the company to be dangerous during August, 1937 when he had his talks with Engstrom and Cunningham, that he loaned the bankrupt an additional $1500 on August 31st, bringing the total of the company's indebtedness to the bank to $6500, it is perhaps a singular coincidence that this $1500 was approximately the same amount that was paid to Engstrom's company to prevent suit being filed against the bankrupt, and it must always be kept in mind that the bank required

Shumway's personal signature on all the notes of the bankrupt. It is also most significant that less than thirty days after this $1500 loan was made, Shumway applied to Gibson for a twenty thousand dollar loan *which was refused* and that only a short time thereafter, and in fact only about five weeks after the bank had so graciously made this new loan of $1500, it received payment of its $3,000 note from the bankrupt, *thirty days before it was due.* To analyze what happened, therefore, it may be said that Carl Gibson (who knew in August of one creditor who was threatening suit against the bankrupt and of "several other accounts" against it "in the same condition") made a loan to the bankrupt of a sufficient amount to stave off suit by the one creditor, giving the company a chance to continue operating for a few weeks more, while the bank prudently collected all of its unmatured notes and so saved Shumway, the bankrupt's president (who discussed all his business with Gibson) from personal liability on these notes.

The bank cannot claim ignorance of facts, nor immunity from performance of its duty, because Carl Gibson, its agent in the matter, had died before the trial of this case. The fair and impartial enforcement of the Bankruptcy Act for the protection of all the creditors of a bankrupt estate demands that death shall not be used as a shield to prevent the recovery of unlawful preferences, and undisputed evidence in the record should not be so aided by purely speculative inferences, as to relieve the bank from the responsibility with which it was indubitably charged through its deceased officer and agent.

As was said by Chief Justice Taft in the Cunningham v. Brown case, supra, the principle that "equality is equity" is the "spirit of the bankrupt law", and it is contended by petitioner that here as there, the bank in its successful "race of diligence", inspired by its inside knowledge of facts and conditions, violated the spirit of the Act and secured an unlawful preference.

THIRD.

The court erred in reversing the judgment of the trial court and in effect substituting its judgment on facts for the findings and judgment of the trial court in an action which had been tried by the court without a jury, thus setting aside the finding of the trial court, which was sustained by substantial and competent evidence, that the appellant bank had reasonable cause to believe at the time the questioned payments were made to it that the bankrupt was insolvent, and that the payments would enable it to secure a greater percentage of its debt than other creditors of the same class.

The trial court heard and considered all the evidence and its findings admittedly covered every element of voidable preference. The insolvency of the bankrupt for a considerable period of time before the payments were made must be conceded. The evidence adduced on the part of the trustee in bankruptcy to sustain the finding of fact that the bank had reasonable cause to believe the payments to it would effect a preference is shown in the record and citation to this persuasive evidence has been given in the petition

for the Writ of Certiorari. The Circuit Court of Appeals, as is unquestionably disclosed by the language in its opinion, wholly disregarded a large part of this evidence, and obviously gathered a confused understanding of other parts of the evidence as is shown by its erroneous statement of many purported facts, some fifteen instances of which are set forth in the petition.

This action of the court is in conflict with the rule long established by decisions of this Court prior to the adoption of the Federal Rules of Civil Procedure that the findings of fact of a trial court in a case tried without a jury where special findings are made, are conclusive and not subject to review by Circuit Courts of Appeal, if there were *any* evidence to support the findings.

In the case of Stanley v. Board of Supervisors, 121 U. S. 535, 547, 30 L. Ed. 1000, this court laid down that rule in the following language:

> "Where a case is tried by the court without a jury, its findings upon questions of fact are conclusive here; it matters not how convincing the argument that upon the evidence the findings should have been different."

That rule was approved in the case of Dooley v. Pease, 180 U. S. 126, 131, 45 L. Ed. 457, 460, in the following language:

> "Where a case is tried by the court, a jury having been waived, its findings upon questions

of facts are conclusive in the courts of review, it matters not how convincing the argument that upon the evidence the findings should have been different. Stanley v. Albany County Supers., 121 U. S. 547, 30 L. Ed. 1002, 7 Sup. Ct. Rep. 1234.

"Errors alleged in the findings of the court are not subject to revision by the circuit court of appeals or by this court, if there was any evidence upon which such findings could be made. (citing cases)."

Citing the case of Dooley v. Pease, supra, with approval, this Court reaffirmed the rule in the case of United States v. Jefferson Electric Mfg. Co., 291 U. S. 386, 407, 78 L. Ed. 859, 874, in the following language:

"We think there was such evidence. There was conflict in it; parts of it admitted of diverging inferences; and as to some matters the preponderating weight was difficult of ascertainment. But these were all matters for the trial court to determine. It was exercising the functions of a jury and its findings are on the same plane as if embodied in a jury's special verdict."

It is true that the Circuit Court of Appeals here stated in one place in its opinion that there was *no evidence* to support the finding of the trial court "that the appellant knew or should have known that the payment was preferential". There was, of course, no finding by the trial court couched in this language, which does not conform to the requirement clearly set out in the Bankruptcy Act, but it probably referred

to find numbered XIII (Tr. 42), set out in full in the petition. However, in view of the erroneous statement of the appellate court of the evidence in the record, as pointed out heretofore, and in view of its disregard of other substantial and material evidence, which has likewise been pointed out, and in view of its manifest belief that an unnecessary burden of proof was placed upon the trustee, such a statement must clearly be taken as erroneous and not in accordance with the record itself. The only basis it seems to have had for such statment was that it drew different inferences and—petitioner urges, entirely unwarranted inferences,—from undisputed facts, from the inferences drawn therefrom by the trial court, often, as is shown, by a complete misconception of the facts themselves. Petitioner urges that these inferences were not correct presumptions from the facts actually shown if a proper construction were given to the requirements of the proof necessary to establish a voidable preference.

Whether the language of Rule 52 (a), Federal Rules of Civil Procedure, shall be construed as enlarging the functions of the appellate courts so as to permit a Circuit Court of Appeals to substitute its judgment on facts for that of the trial court, as was unquestionably done here, thus changing the rule long established by this court and cited above, is one of the questions petitioner presents here.

It would seem that Rule 52(a) was meant to be merely a restatement of the long established rule laid down heretofore.

It is a rule based on reason and common sense and its limitations on the power of review of facts by appellate courts should not be set aside save for grave reasons. Whether Rule 52 (a) is to be construed as a departure from that rule is for this Court to determine.

CONCLUSION

Petitioner, therefore, respectfully submits that the United States Circuit Court of Appeals for the Ninth Circuit, by setting aside a finding of fact of a trial court which was sustained by substantial and competent evidence, without having adequately considered all the evidence on which the trial court based its findings and judgment, and upon an erroneous interpretation of the proof required by the Bankruptcy Act to sustain the findings, has so far departed from the accepted course of judicial prodecure as to call for the exercise of this Court's power of supervision, and that this is a proper case for the issuance of this Court's Writ of Certiorari.

Respectfully submitted,

ALEXANDER B. BAKER,
Counsel for Petitioner

ALICE M. BIRDSALL
Of Counsel